Future Generation and 2Fold: Take Stock

Caroline Gurney and John Coombe

Future Generation acknowledges the Traditional Owners of Country throughout Australia, and recognises their continuing connection to lands, waters and communities. We pay our respects to Elders past and present.

CAROLINE GURNEY: Hello and welcome to Take Stock, a new podcast by Future Generation. I'm Caroline Gurney, the Chief Executive of Future Generation, and today I'm speaking to John Coombe. John is the Executive Director of Jana Investment Advisers. He advises some of Australia's biggest super funds and he is an expert in the field. John is on the Investment Committee for both Future Generation Australia (ASX: FGX) and Future Generation Global (ASX: FGG), and we think he is the best person to talk to and update you on what's happening both in the portfolios and in the markets in which we operate. John thank you very much for being here.

JOHN COOMBE: Thank you Caroline. A first for me.

CAROLINE GURNEY: Excellent. I'm so glad we could make that happen. So John to kick off, Future Generation Australia we weighted pretty heavily towards small to mid-cap companies. Because you're on the Investment Committee, I really want you to explain how that weighting occurred and then give us an idea of the rough split between small and large caps in our portfolio please?

JOHN COOMBE: So let me start with the second part first. We're about 25% overweight small caps and about the same underweight for large caps. The reason why that came about is because we tend to hire a lot of boutique managers. And a lot of the boutique managers have identified - rightly so, I might add - that the small cap area of the market is where you get the biggest bang for your dollar, in terms of return over the medium to longer term. Now it's logical when you think about it. If you're a start-up company, you start down the bottom of the index and, as you grow your market share, as you grow your earnings, as you build out your company profile, and you might go global or you might stay domestic, you'll generally get bigger earnings as you become a bigger part of the index. JBHiFi (ASX: JBH) was a classic for that, remember. It started off as a small little boutique out of Melbourne and it's grown into a national brand. And managers who bought it at the start and held it and probably still hold today have made a fortune out of that stock as it's grown out its business over time. So, you can understand why managers who want to generate a lot of alpha tend to be overweight in mid-caps, small caps. The irony is that, statistically, you don't really see a small cap effect in Australia, but we know from the alpha generated by the managers we hire that there's a definite effect of managers being able to generate alpha from that part of the market.

CAROLINE GURNEY: So maybe we could actually look at small cap companies because they have underperformed in the last couple of years. We're aware of that. So, can you give us some context as to why that's happened in Australia firstly?

JOHN COOMBE: Yeah because typically in a risk off environment, small caps tend to underperform. They're more sensitive, so they tend to be linked to the economy more and so they take the pain of any slowdown in the economy much worse than, say, a large cap which has a much broader base. And, to be blunt in Australia, we've benefited a lot in the last 2 years from the Mining stocks. You've seen the big BHPs (ASX: BHP), Fortescues (ASX: FMG), etcetera do really, really well because the prices being paid for those commodities has stayed a lot higher than most people thought they would, partly due to China etcetera. It's really been a very interesting market from that perspective.

CAROLINE GURNEY: With the Investment Committee, did you consciously change the investment portfolio to remove or reduce the small bap bias at all?

JOHN COOMBE: No we didn't because over the medium and longer term, when you look at our 5-year numbers, our 10-year numbers etcetera, it's been a really positive part of the portfolio in adding value over time. So, we genuinely believe in that small cap alpha impact. The managers who are attuned to the company management and where they're going to set that portfolio and set their aspirations over the next 5 years, we want to be in that sweet spot. So, we didn't. And, to be blunt Caroline, we would've had to have taken some of our very best managers and taken money away from them and we might not have been able to get it back in, given that they're constrained about how much money they might take in their strategies. Personally, I'm very comfortable with where we sit today looking on a 5-year view because as the economy picks up again, after we come out of what might be a mild recession, as the economy picks up at the other end, those small cap companies will outperform the larger companies.

CAROLINE GURNEY: Maybe if you could expand a little bit more on your outlook for the sector of the market?

JOHN COOMBE: When you look at it on a price to earnings [basis], the small caps are cheap relative to the large caps. They're trading on around 10 times and the large caps are sort of up in the 18 times. So, from that perspective, do you want to pay $10 dollars for a $1 dollar of earnings or do you want to pay $18 dollars for $1 dollar of earnings? Well, I'd pay $10 dollars because over time if they grow those earnings faster than the rest of the market, you've bought into a really cheap company. Now, they haven't been this cheap for quite some time, so you've got to go back into the GFC (Global Financial Crisis) to see where small caps were as cheap as they are today. Now, admittedly in the GFC, large caps got cheap as well so you had a choice. But really today small caps stand out.

CAROLINE GURNEY: So I think that's quite a good chance for us to actually turn to Future Generation Global. So, FGG has also got a bias towards small to mid-cap players, but it's nowhere near as marked as what we have in the Future Generation Australia portfolio. What's the rough split there?

JOHN COOMBE: About 16%, but the biggest underweight is to the really mega stocks. That's your Apples and Meta...

CAROLINE GURNEY: Alphabet etcetera.

JOHN COOMBE: Alphabet, all of those lovely names.

CAROLINE GURNEY: So maybe let's go into what's been happening globally in the small cap market?

JOHN COOMBE: Well...

CAROLINE GURNEY: The Magnificent Seven.

JOHN COOMBE: The Magnificent Seven have done an amazing job. In reality, the top 10 holdings in the world now account for 20% of the market cap. We haven't seen a concentration level like this for decades. I think you would have to go back to the 2000 tech boom.
Those companies have really re-rated. In the 6 months between the 30th December to the 30th June, those 7 stocks - and we're talking about Apple (NASDAQ: AAPL), Microsoft (NASDAQ: MSFT), Alphabet (NASDAQ: GOOGL), Amazon (NASDAQ: AMZN), Nvidia (NASDAQ: NVDA), Tesla (NASDAQ: TSLA) and Meta (NASDAQ: META) - are up 90%. The multiple has expanded 147 times, right? So, you haven't got any extra earnings, they're actually just re-rated. The market has just fallen in love with them. The worst one is Nvidia. It was trading on 62 times PE [price to earnings]. It is now trading on 220 times PE. That's a multiple movement of 254%. So, if that's not speculative, I don't know what is. Its total return is nearly 200%. Well, that's amazing, isn't it? This is because they bought out ChatGPT and the market has gone mad over it. Now, the real test for that company is to commercialise that and to actually raise all of that revenue that the market thinks it's going to do. That's a huge, huge rerating. But, even a stock like Microsoft, which people love, wonderful stock, it's up 43%, but it's all multiple. The multiple has gone from 26 to 37 times. So, it's really about the market just saying technology looks to be the new area that we all want to focus on. It's the thing that's going to give us productivity gains. Really, no one knows how AI is going to impact even what we do, Caroline, in terms of analysing mining reports etcetera. There's so much talk about how it's going to change what we do in our everyday life. So, it will be an amazing journey and I have no doubt that some of these stocks will be massive big winners. Like, if you go back to 2000, when Amazon was just a book seller and today it's this massive retailer and has changed its business mix two or three times. It's now a big provider of data centres and data storage, so businesses that have free cash flow can change the nature of the business as well. So, we're not saying these stocks are going to be losers, but over time they generally have a pullback. We saw that last year when a lot of these big mega stocks were down 30 or 40%. The market's a fickle baby, it does have its favourites at times, and at the moment it's technology and it's anything that has the word "AI" in it.

CAROLINE GURNEY: So it's really reminiscent, isn't it, of the FAANG group?

JOHN COOMBE: Yeah.

CAROLINE GURNEY: So that was like a tearaway leadership group as well. Is that transient or long lasting? What do you think? What are your thoughts on that?

JOHN COOMBE: If the earnings come through, it's long lasting because the market always rewards earnings growth. So, if you look at Apple, it has been able to grow its earnings and continues to be able to grow its earnings. Now, when it doesn't meet market expectations like it sometimes doesn't, then the market punishes it. When you've got a high expectation of earnings growth and you don't live up to the market's expectations, you get punished. We've seen Microsoft at different times being unloved by the market because in the old days it didn't have a recurring income stream. Now, it's all online, you do all your backups, it does data storage, it does all of those things for you. So, businesses have to adapt to the market environment to stay in front of it. Look, every one of these businesses is talking about how AI is going to be a positive for their business. In Microsoft and Apple's case, it's data storage. Amazon, it's data storage. So, you can understand why the markets are looking the way they do at the moment. But the real test is earnings out over a 5 year period. Can they grow the earnings to the market expectations?

CAROLINE GURNEY: So, let's look at small caps globally because obviously that's where we are placed and that hasn't been very good. But are you seeing signs there of a resurgence?

JOHN COOMBE: Yes. Look, I hate talking really, really short term, but I get a weekly chart service that comes from a guy who looks at a whole lot of charts in the United States and looks at different trends. One of the trends that has become apparent over the last 2 weeks is basically the market is broadening out. This came home to me the other day when one of my research guys basically put it in this context: in the last 6 months, the movement in those 7 stocks is the equivalent of three high yield on markets. That's how much their market value has gone up. It feels a bit like a bubble, it probably is a bit of a bubble. Maybe it is just that the market rotates down into other stocks, or they disappoint on earnings and they get rotated out of. But generally stocks do come back off these mega highs.

CAROLINE GURNEY: As I said, you're on the Investment Committee for Future Generation Global and last year we brought in 5 new pro bono fund managers and we're seeing some benefits flow in from those. What was the thinking behind making those changes?

JOHN COOMBE: We just wanted a broader set of managers. We had a couple of managers who were very keen to be a part of the whole process. When we looked into them, they fitted into things we were missing in the portfolio. We wanted a bit more breadth, so we put in a couple of quant [quantitative] managers. There were a couple of Australian quant managers, who were going into global and they really wanted to be a part of FGG. That was fantastic and so that gave us a bit more stability in the portfolio, in terms of broad market coverage. It also took some of the stock specific risk that we had in the portfolio, which we were a bit uncomfortable with.

CAROLINE GURNEY: Despite the improvements in performance, we're still seeing that FGX and FGG are trading at a hefty discount…

JOHN COOMBE: Yep.

CAROLINE GURNEY: …and I know you're a shareholder in both of these companies, so how are you feeling about these two stocks?

JOHN COOMBE: Oh I just bought more. I've got a dividend cheque out of my super [superannuation] fund and I basically bought two stocks. I just thought they were trading at crazy discounts, so I just bought more. I think anything that trades under a 10% discount, you've got to look at it and say, "Well, even if they just get back to market over the next 12 months, that's a 10% improvement over the market return that I'm going to get just from that narrowing of the discount." So, I've got my fingers crossed that the discount gets narrowed. And, as I've always said, if you're a stockholder and it's trading under a 10% discount, you should be thinking about putting the marginal dollar in because that's the only way you'll get that discount down.

CAROLINE GURNEY: And is there anything else that I should be asking you that you think about all the time?

JOHN COOMBE: I think we think about if we've got the right mix in the portfolio a lot. As you know, we've just spent a bit of time with both of the Investment Committees looking at our charter, looking at our policies, and just thinking about the structure that we have in the portfolios. I think we're very conscious about delivering on the promise to shareholders, which is to give the market return or better, protect a little bit in down markets. We're very conscious that when we're looking at the portfolio and the managers' structure, are we delivering on those promises to shareholders?

CAROLINE GURNEY: Thank you. Thank you very much John for your invaluable insights but also for the work that you do pro bono on both of the Investment Committees. Thank you very much for joining us, John.

JOHN COOMBE: Pleasure Caroline.

CAROLINE GURNEY: Thank you.
[End]